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Report of the Secretary-General

Summary

The present report, submitted in response to General Assembly resolution 63/205, complements the reports of the Secretary-General on the follow-up to and implementation of the outcome of the International Conference on Financing for Development and on external debt and development. It reviews recent trends in international official and private capital flows to developing countries and international policy challenges arising from the financial crisis, particularly the impact of the crisis on development financing. The report highlights the urgent challenges that need to be addressed by the international community in reforming the international financial system in light of the weaknesses exposed by the global crisis.

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I. Net transfer of financial resources of developing and transition economies

A. Continued substantial net resource outflows from developing countries in 2008 and 2009

1. Developing countries continued to make substantial net outward transfers of financial resources to developed countries, with the amount reaching $829 billion in 2008 (see annex). The magnitude of that transfer is expected to decline to a still substantial $448 billion, an indication of the unwinding of those imbalances spawned by the ongoing global financial and economic crisis. Sharp increases in export earnings in many African and West Asian countries and in economies in transition, as a result of the sharp run-up in commodity prices in 2008 and which were not consumed by increased imports, resulted in accumulation of reserves and continued outward investment on a net basis by those regions. In regions other than Africa and West Asia and the economies in transition, net outward investment and in accumulation of reserves continued in 2008, but, compared with previous years, the total level of such movements moderated, as the value of their export earnings, mostly from manufactured goods, declined in line with the contraction of world trade in goods. Estimates for 2009 indicate that, as a result of the collapse in the export earnings of developing countries brought about by the simultaneous economic slump in all the major economies, previously negative net transfers will turn positive in favour of Africa, Latin America and the least developed countries, as those countries move from trade surpluses to trade deficits. Overall financial transfers from East and West Asia in favour of developed countries will still be significant, because public sector reserves accumulation appears to be continuing and declines in import levels are exceeding export losses.

2. The structure of flows behind the still substantial negative financial transfers in 2008 and those preliminarily estimated for 2009 indicates that, for the most part, a disorderly unwinding of accumulated global imbalances is under way, a prospect that the United Nations has warned of in recent years. The world economy is forecast to contract by as much as 3.4 per cent in 2009, and world trade volume by at least 10 per cent. Since private flows are highly cyclical, foreign direct investment and portfolio flows to developing countries have fallen sharply. Commodity prices have also fallen sharply. The reduction in total negative financial transfers from developing countries is associated with collapsing demand, employment and incomes in both developed and developing countries. Inadequate coordination of public sector stimulus packages among developed countries and constraints on similar packages in most developing countries are threatening to prolong the recovery in global economic activity. As discussed extensively at the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, held from 24 to 26 June 2009 in New York, in developing countries the drastic downward adjustment of export sectors is imposing severe and potentially long-lasting hardships on women and the poor. Public sector revenues in developing countries have fallen sharply as a consequence of the fall in exports.

3. A more orderly and, in human terms, less costly reduction of international financial transfers from poor to rich countries would require faster demand growth in developing countries. However, most developing countries have limited monetary and fiscal space to maintain domestic demand. This space is being further

constricted by the crisis and by programmes with deflationary consequences required or promoted by the international financial institutions. The accommodation by the Group of 20 (G-20) countries to provide additional resources for developing countries, loaned through the international financial institutions, especially the International Monetary Fund (IMF), is welcome but insufficient to meet the estimated needs to make up for falling private sector demand worldwide. Moreover, most of the additional resources, except for the proposed new allocation of special drawing rights (SDRs) equivalent to $250 billion (which would be allocated on the basis of quotas and the vast majority of which would not be available to developing countries), will be channelled through conditional, debt-creating programmes, with consequently greater prospects for a new wave of developing country debt crises in the medium term.

B. Sharp reversal of private capital inflows and rising costs of external financing

4. Private capital flows to developing countries have dropped sharply in the wake of the global financial crisis. In tandem with this trend, there has been a sharp rise in external financing costs for developing countries. An illustration of this is the huge increase in the risk premium on lending to emerging economies (a grouping of some 30 large developing countries and economies in transition), from 250 to about 800 basis points, during the third quarter of 2008. Moreover, the increase in risk spreads has been uniform across developing regions, confirming the existence of contagion and generalized investment aversion in global financial markets. Despite narrowing earlier this year, risk spreads remain very high relative to normal market conditions.

5. As a result, net private capital inflows to emerging economies are estimated to have declined by more than 50 per cent during 2008, dropping from a peak level of more than $1 trillion in 2007 to less than $500 billion. A further dramatic decline — of 50 per cent — is expected for 2009.

6. The decline in private capital inflows encompasses all developing regions, with the most substantial decrease taking place in emerging economies in Europe. This trend will also have an impact on parts of Africa, since the continent has also been relying increasingly on private capital inflows, though such flows are small in global terms. In fact, given the size of most domestic capital markets in Africa, even a small decline in these inflows could have a sizeable impact on the price of securities. There were no international bond issues by African countries in 2008, as a consequence of the global credit crunch. Some countries, notably Kenya, Nigeria, Uganda and the United Republic of Tanzania, have had to cancel plans to raise funds for infrastructure projects in international capital markets.

7. Among all the components of net private capital inflows, the sharpest drop was in bank lending to emerging economies, reversing from inflows of about $400 billion in 2007 to a projected net outflow in 2009. Institutional investors in developed countries are expected to continue reducing their exposure in emerging economies, while international banks may further curtail their cross-border lending. Various banking rescue measures adopted in developed countries may exacerbate this trend.

8. The sharp fall in foreign direct investment (FDI), which contracted by about 15 per cent in 2008, has been driven by a marked weakening in corporate profits and falling global capital spending. In addition, the collapse of primary commodity prices and weakening real estate prices in many developing economies have also reduced FDI in those sectors. Most worrying, falling FDI flows could also have implications for infrastructure projects, which are critical for longer-term growth. A significant infrastructure financing gap has already emerged in many developing countries, with longer-term needs far exceeding the amounts that are currently being invested.

C. Official development assistance targets at risk

9. Total net official development assistance (ODA) from Development Assistance Committee members rose in 2008 by 10.2 per cent in real terms to $119.8 billion, reaching the highest dollar figure ever recorded, and reached 0.30 per cent of the combined gross national income of donors. In particular, bilateral development projects and programmes rose by 12.5 per cent in real terms compared with 2007, indicating that donors were substantially scaling up their core aid programmes. Preliminary data for 2008 show that net bilateral ODA to Africa totalled $26 billion, of which $22.5 billion went to sub-Saharan Africa. That was an increase of 10.6 per cent and 10 per cent, respectively, in real terms, excluding volatile debt relief grants. Among Development Assistance Committee members, the largest contributors in terms of gross ODA were the United States of America ($26.9 billion), Japan ($17.4 billion), Germany ($15.9 billion), France ($12.4 billion) and the United Kingdom of Great Britain and Northern Ireland ($11.8 billion).

10. Total aid from the United States increased in 2008 by 16.8 per cent in real terms, compared with a decline of 9.9 per cent in 2007, and its ODA share of gross national income has now risen to 0.18 per cent. While aid from the United States increased to practically all regions, aid to sub-Saharan Africa rose sharply, by 38.3 per cent in real terms, to $6.5 billion, and aid to the group of least developed countries rose by 40.5 per cent in real terms, to $6.9 billion. Thus, the promise of the United States to double aid to sub-Saharan Africa by 2010 appears to be on track. Japan also reversed the downward trend in its ODA that had persisted since 2000, except in 2005 and 2006 when high levels of debt relief occurred. Net ODA from Japan in 2008 was $9.4 billion, representing an increase of 8.2 per cent in real terms compared with 2007, when it fell by 30.1 per cent. The increase was mainly the result of a rise in contributions to international financial institutions. Japan has announced that it intends to fulfil its promise for an overall volume increase of $10 billion over the period from 2005 to 2009.

11. The combined net ODA of the 15 European Union members of the Development Assistance Committee, which accounted for almost 60 per cent of all ODA from the Committee, also rose by 8.6 per cent in real terms to $70.2 billion in 2008, compared with 2007 when it fell by 5.8 per cent in real terms. As a share of gross national income, net ODA from European Union members of the Development Assistance Committee rose from 0.40 per cent of their combined gross national income to 0.42 per cent in 2008. Australia, Belgium, Canada, Germany, Greece, New Zealand, Portugal, Spain and the United Kingdom also reported significant increases in their ODA in 2008.

12. However, there is fear that the strain of the crisis may lead to decreases in aid volumes, including aid for trade, as happened during the global economic recession of the early 1990s, which produced large fiscal deficits in donor countries and led to deep cuts in ODA, from 0.33 per cent of gross national income in 1992 to 0.22 per cent in 1997. Estimates differ among donors, but a 1 per cent negative growth shock implies an 8 per cent reduction in aid budgets five years after the shock, according to a recent study.[1] Such a reversal at the present juncture would place a dangerous additional burden on developing countries, which are already struggling with restricted sources of income and increased poverty, and would undo some of the progress made towards achieving the Millennium Development Goals.

II. Strengthening the international financial architecture

13. The United Nations Conference on the World Financial and Economic Crisis called for urgent reform of the international financial system and architecture, including in areas related to mandate, scope, governance, responsiveness and development orientation. There are five key areas in which progress is urgently needed: international financial regulation, multilateral surveillance, IMF lending and resources, the international system of payments and reserves and governance reforms in the Bretton Woods institutions.

A. Increasing international cooperation on financial regulation

14. The crisis demonstrates the urgent necessity for introducing an international regulatory system over the globalized financial system with sufficient transparency for investors and regulators, so that financial leverage levels do not endanger the stability of the whole system, and for generating less volatile financial flows for innovation, risk-taking and investing in employment, production and development. The United Nations Conference on the World Financial and Economic Crisis called for expanding the scope of regulation and supervision and for making them more effective with respect to all major financial centres, instruments and actors, including financial institutions, credit rating agencies and hedge funds.

15. In their Declaration on Strengthening the Financial System,[2] adopted in London on 2 April 2009, the G-20 countries declared their shared intention to reshape regulatory systems to identify and take account of macroprudential risks, expand the perimeter of regulation and oversight to all systemically important financial institutions, instruments and markets, mitigate pro-cyclicality in prudential regulation, strengthen capital and risk management, implement new principles on executive remuneration and improve standards on valuation and provisioning.

16. With competing national financial centres among which financial companies can choose to locate their activities in order to exploit regulatory advantages, such reforms will be successful only if coordinated internationally. Although of critical importance, the effort to achieve sufficient coordination and harmonization of

[1] Emmanuel Frot, "Aid and the financial crisis: shall we expect development aid to fall?", working paper, Stockholm Institute of Transition Economics, available at www.voxeu.org/index.php?q=node/3562.

[2] Available at www.g20.org.

national regulatory policies is a difficult undertaking, as in the foreseeable future no country (with the possible exception of some European Union members) is likely to delegate decisions about the supervision and regulation of its financial institutions or national financial system to external bodies, thereby giving up national sovereignty over a key issue of economic policy.

17. In the context of the ongoing crisis, previous well-meaning efforts to strengthen cooperation through the deliberations of the Financial Stability Forum, the Basel Committee on Banking Supervision and colleges of supervisors have proven inadequate. Existing institutional arrangements to ensure that national decisions regarding regulation appropriately take into account both external and domestic consequences remain ineffective. There exist important inconsistencies among regulatory systems across countries as well as a clear tendency for country authorities to privilege domestic interests and disregard the adverse international spillovers of their actions. The difficulty of better aligning national and global interests, along with other structural, political, cultural and legal constraints, has significantly hampered effective cross-border supervision.

18. Enhanced cross-border coordination and cooperation must be accompanied by a clear commitment to avoid fragmentation and regulatory protectionism resulting from actions taken at the national and regional level to address the crisis and its aftermath. It is important to avoid a drift back to a system of national and regional financial fiefdoms. Accordingly, particularly in developed countries, actions to support banking systems should not distinguish between domestic and foreign-owned institutions, nor should credit be diverted to domestic borrowers through subsidies or inappropriate regulatory incentives. While the same underlying principle would be applicable in developing country financial markets, the application of the same principle in those markets should take into account the fact that domestic firms did not enjoy the incentives many foreign financial firms received when they entered those markets and thus should have preferential access to public support programmes during the crisis. Unfortunately, an uncoordinated process of building up national and regional controls is already under way in many countries. It will likely continue unless much better structures for cooperation and coordination are developed.

19. The crisis has confirmed the harm created by regulatory loopholes and regulatory arbitrage. There appears to be an agreement in principle, but not in practice, that regulatory coordination is necessary to ensure that prudential regulation is applied consistently across countries and financial activities. The international community must articulate and affirm essential principles and standards of financial market regulation and find a mechanism for continuous oversight of progress on coordination and cooperation.

20. Another important gap is incompatibility among bank insolvency frameworks, especially in the case of inconsistencies between the home and host countries of financial institutions. There is a need for a consistent set of international guidelines to manage the resolution of failures of financial companies. In the cross-border context, one of the most important and difficult issues is burden-sharing. For burden-sharing arrangements to be credible, they should be legally binding and based on objective criteria in order to ensure an equitable distribution of costs.

21. Better coordination is also needed to ensure more consistency in depositor and investor protection schemes across countries. Explicit coordination principles

should help to mitigate destabilizing capital flows, including deposits, from one country to another during periods of market stress and uncertainty. For instance, it has been noted that in the current crisis the introduction of Government guarantees in respect of the assets and liabilities of domestic banks in some developed countries put pressure on less protected systems in neighbouring countries, exposing them to runs on deposits. The network of Government support in advanced countries also put pressure on emerging market banks.[3]

22. In the course of managing the crisis, cross-border information flows have been found to be inconsistent, with data about cross-border risk exposure being incomplete and systemic connections among financial institutions not adequately appreciated. In this regard, it has been suggested that supervisors in different countries should have prior agreements on what information relevant for systemic stability to collect and communicate and on arrangements that provide them with clear legal obligations, along with the powers to share this information with external authorities.

23. While there is a broad agreement on the need to improve cooperation and communication among regulators, there are differing viewpoints on how to strengthen international regulatory cooperation. The approach of the G-20 has been to strengthen existing arrangements, requesting the Financial Stability Board, with its recently expanded membership, to set standards and requesting IMF to assess whether national regulation meets those standards. This will expand the surveillance role of the Fund to the overlooked intersection between national macroeconomic policies and the supervision of individual financial institutions and national financial systems. In the context of the recent helplessness of the Fund in performing within the original scope of surveillance duties, there are doubts about the legitimacy, accountability and effectiveness of this arrangement.

24. The most ambitious alternatives are proposals for new institutions or approaches to regulation, implemented through a new multilateral mechanism, such as a world financial organization that would be analogous to the World Trade Organization, an international bank charter or an international insolvency mechanism. According to proponents, the new organization would establish principles for prudential supervision, define obligations for its members, appoint independent panels of experts to determine whether countries were in compliance with those obligations and authorize the imposition of sanctions against countries that failed to comply. A less ambitious approach would be the setting up of a council for regulatory coordination under the aegis of the Financial Stability Board. Such a council would be mandated to reinforce operational cooperation between IMF and the Financial Stability Board and strengthen global efforts on harmonization and coordination.

25. A key issue in cross-border bank solvency resolution frameworks is the sharing of costs among public authorities involved in such efforts. In this regard, there have been proposals for an international bank charter spelling out the procedures for joint risk assessment, remedial action and burden-sharing among countries. There have also been calls for a universal venue, guided by international

[3] International Monetary Fund, "Initial lessons of the crisis for the global architecture and the IMF", 18 February 2009, p. 7, available at www.imf.org.

law, where cross-border insolvencies of internationally active financial institutions could be administered.

26. A less demanding approach to cooperation in bank solvency resolution is exemplified in the "colleges of supervisors" mechanism promoted by the G-20. At its April 2009 meeting, the G-20 agreed to establish the remaining supervisory colleges for significant cross-border firms, building on the 28 already in place. These colleges, consisting of home and host supervisors, are collectively responsible for the effective supervision of large cross-border institutions, including assessing risk concentration and major strengths and weaknesses, in addition to deciding on the permissible activities of firms. One of the key issues on the supervisory college agenda is to agree on concrete steps to codify closer home-host collaboration, including explicit agreement on actions to address vulnerabilities early. Also, in the absence of the above-mentioned bank charter, colleges could be an arbiter for home and host supervisors on bank resolution.

27. It is also worth noting that the fragmented nature of domestic regulation in many countries also requires urgent attention. Indeed, even within national boundaries, there remains the potential for jurisdictional conflict and miscommunication between competing laws and regulatory bodies.

B. Multilateral surveillance and policy coordination

28. In discussing the causes of the economic crisis, the outcome of the United Nations Conference on the World Financial and Economic Crisis highlighted "major failures in financial regulation, supervision and monitoring of the financial sector, and inadequate surveillance and early warning" (General Assembly resolution 63/303, annex, para. 9).

29. Surveillance remains IMF's key crisis prevention tool. Progress remains to be made in its design and implementation, however. Since the 1980s, IMF has mainly been focused on problems in emerging markets and developing countries, devoting insufficient attention to major financial centres and vulnerabilities in global financial markets. To close this gap, the Fund's vulnerability analysis is being expanded to advanced economies and integrated with the early warning exercise. Nevertheless, much work still needs to be done to improve surveillance over the mature financial markets and advanced economies. This will be essential for ensuring that a reformed IMF remains relevant and properly discharges its mandate in promoting global economic and financial stability.

30. Fund surveillance can only be effective to the extent that members are cooperative and responsive as far as the implementation of recommendations is concerned. Indeed, many of the imbalances that led to the crisis were identified by IMF and other international organizations. However, there was a failure to act on available information. The challenge is to ensure that, in going forward, the relevant information is used proactively to mitigate future crises.

31. One of the most important areas of the Fund's work is surveillance over the exchange rate policies of its members. In June 2007, the Executive Board approved an updating of the 1977 decision on surveillance over exchange rate policies. The update puts exchange rate assessment at the centre of IMF bilateral surveillance,

while external stability becomes the overarching principle of the surveillance framework.

32. The 2007 decision aims at providing a coherent framework within which exchange rate issues can be assessed in the overall context of external stability. However, an overreliance on quantitative models may divert attention away from a meaningful analysis of external and internal stability, and from consideration of economic policy as a whole. In assessing the external stability of Fund members, a focus on the exchange rate as the sole determining variable could prove to be unrealistic and ineffective. Fund analysis of individual countries should remain comprehensive, taking into account the overall macroeconomic situation, with an emphasis on the consistency and sustainability of the overall policy mix. The surveillance should take into account all the relevant challenges that determine macroeconomic stability in specific contexts. More needs to be done in this field to ensure effective and even-handed implementation of surveillance activities.

33. While the traditional emphasis of the Fund has been on exchange rates, the crisis has pushed macrofinancial as well as macroprudential and microprudential issues onto centre stage in IMF surveillance. In this regard, more attention should be given to financial risks, including asset price bubbles, leverage, risk concentration in large banks and hidden or off-balance sheet exposures. A key aspect here is the integration of macroeconomic and financial sector surveillance, the focus on the linkage between the macroeconomy and the financial markets and the soundness of the financial sector of member countries. The challenge for policymakers at both national and international levels is that there is no agreed conceptual framework to guide international cooperation on these related dimensions of policy.

34. IMF, as a global institution with substantial analytical capacities, could play an important role in helping to reach a consensus on these issues and in implementing the resulting arrangements. To this end, a joint IMF-Financial Stability Board early warning exercise may help to establish a less fragmented and more pointed surveillance system. Indeed, the exercise will combine the macrofinancial expertise of the Fund with the regulatory experience of the Board to produce a more systematic view of evolving global risks. The final outcome of the early warning exercise is expected to be policy advice to mitigate these risks.

35. In addition, the Financial Sector Assessment Programme needs to be made more focused, risk-based and forward-looking, with a greater emphasis on external links and spillovers. It has also been decided that financial sector surveillance should be embedded more effectively as an element of article IV consultations and its results integrated into the broader macroeconomic surveillance work.[4] As for the implementation of the Financial Sector Assessment Programme, it is worth noting that all G-20 members have committed to undertake the Programme.

36. G-20 leaders called on the Fund to regularly assess the actions taken and actions required to revive global growth. It is also important to evaluate the costs and impacts of the large fiscal stimulus measures, in addition to their long-term macroeconomic implications. For many advanced economies, there is an urgent need for medium-term policy frameworks to anchor expectations and reassure markets of the long-term sustainability of fiscal positions.

[4] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 25 April 2009, available at www.imf.org.

37. Moving beyond the resolution of the current crisis, enhanced international cooperation should aim at a rebalancing of global sources of growth and a reduction of savings-investment gaps. In this regard, there have been serious concerns expressed that policymakers may now be sowing the seeds of future boom-and-bust episodes by taking actions that may slow, or possibly prevent, necessary global adjustments by providing "too much" demand stimulus. While reversing public demand injections will be necessary at some point in the future, current indicators point to a much greater danger of deflation, which a premature reduction of public spending will only exacerbate.

38. The primary long-term goal of enhanced surveillance must be to reduce global imbalances and prevent the re-emergence of those imbalances that contributed to the current crisis. This can only be accomplished if key systemically important countries take a coordinated approach to fiscal and monetary policy, with the aim of shifting aggregate demand from deficit to surplus countries.

39. The current crisis has brought to light important weaknesses in international cooperation and coordination. In this regard, it has been stressed that, even where the problems were well understood, there was no agreement on responsibilities or means to enforce the necessary cooperative actions. Consequently, it is necessary to build an effective framework for enhanced multilateral surveillance and policy coordination against the backdrop of planned governance reform in IMF and other global institutions.

40. Without a political agreement in this area, any solution of the present crisis will only be partial and inadequate. Moreover, if such a framework or forum for policymakers with the authority to address global systemic concerns is not established, it is unlikely that the enhanced resources and mandate will be enough to forestall future crises. There is a need to promote an adequate level of coordination, whether under the auspices of IMF or not, towards mutually compatible policies on fiscal, monetary and exchange rate issues, including mechanisms of accountability and enforceability in the application of these policies.

41. The ongoing crisis has shone a new light on policy coordination on economic and financial requirements. However, the logic that joint action is more effective and that individual actions undertaken by countries to save only themselves at the expense of other countries (called "beggar-thy-neighbour" policies) have to be avoided still needs to be realized in effective multilateral action. For that to happen, however, a whole spectrum of world economic governance issues needs to be urgently addressed.

C. International Monetary Fund lending and resources

42. Amid the current financial market turmoil, the need for providing official liquidity has once again become the primary focus of Governments around the world. Since the onset of the crisis, IMF has been providing large-scale financing (after a recent period when only a handful of countries was drawing on its resources) to countries experiencing a reduction in the availability of external funding. As at May 2009, the lending commitments of the Fund had reached a record level of $157 billion, including a sharp increase in concessional lending to low-income countries. An important characteristic of new IMF lending arrangements has been their exceptionally large size in relation to country quotas.

The conditions of the recent loans have been fewer and more targeted than in the past, but more concentrated on key pro-cyclical features of IMF conditions.

43. Along with meeting immediate country needs, the Fund has moved to overhaul its lending toolkit and conditionality framework to increase the effectiveness of its crisis prevention and resolution efforts. The Fund has doubled all loan access limits, including for low-income countries, and the surcharge framework has been simplified.

44. In March 2009, the Flexible Credit Line, a crisis prevention instrument, was established. The purpose of the Flexible Credit Line is to provide a signal to international markets of the availability of rapid, large and upfront access to Fund resources in cases of need with no ex post conditionality for pre-qualifying members based on a determination of their having "strong economic policies and a proven track record". Colombia, Mexico and Poland have already signed up for this new facility, for an amount totalling $78 billion. The Fund has also indicated that it is committed to providing larger amounts and more upfront financing across a wide range of its facilities. It is not clear if a large number of countries will find this facility useful, especially in East Asia, where successful international integration has relied much less on external finance. In this regard, it is not clear whether the private sector is sufficiently assured by the Fund's assessments of strong economic policies and a proven track record demonstrated by granting a Flexible Credit Line. In fact, the existence of such a large commitment of Fund member resources to a few countries also creates moral hazard in favour of the international private sector by guaranteeing financing and inadvertently allowing rapid withdrawal of investments from Flexible Credit Line programme countries.

45. Other middle-income countries may need a large precautionary arrangement but may not qualify based on the criteria of "strong economic policies and a proven track record", thereby, based on the logic of the effort, requiring IMF-impelled policy adjustment. For this purpose, the new High Access Precautionary Arrangement is also characterized by large and front-loaded access, but imposes ex post performance requirements. As in previous attempts to provide precautionary financing programmes, the existence of two precautionary facilities has raised concerns that the choice between a Flexible Credit Line and a High Access Precautionary Arrangement inevitably requires potentially controversial judgements regarding the strength of underlying policies, economic fundamentals and the track record of member countries, leading to often arbitrary differentiations among them.

46. Since IMF emergency lending in large volumes is meant mainly to respond to situations of capital reversals, policy conditionality should logically include measures to stem the size and volatility of capital flows, which can potentially be an element of High Access Precautionary Arrangements but not of Flexible Credit Lines, and requires a reversal of the Fund's aversion to capital controls. The Fund needs to support Government policies to exercise prudential regulations for managing the impact of external flows on domestic balance sheets, if only to minimize its own liability to provide financial injections in crisis situations.

47. Starting 1 May 2009, structural performance criteria have been discontinued on all IMF loans, including programmes with low-income countries. The focus of conditionality is shifting to an ex ante and review-based approach. Therefore, structural reforms will continue to be part of IMF-supported programmes but will only be included when considered critical to a country's recovery, in contrast to the

previous approach, which always included a panoply of structural reform conditionalities, including requirements unrelated to the problems at hand. As identified in many studies, including research by Bretton Woods institutions staff, structural reforms tend to enhance pro-cyclicality, while macroeconomic reforms have a deflationary bias, constricting public investment and social expenditures critical to long-term development.

48. Strong, credible policy frameworks are necessary, for which there is an urgent need for greater clarity regarding which policies are actually effective, given that the current situation has raised many questions about the standard framework. In fact, there is now often a stigma attached to seeking support from the Fund, signalling underlying policy weaknesses which can be exacerbated in the course of a Fund programme. Reducing this political stigma is considered vital to increasing use of the Fund by its members, thus enabling the Fund to play a greater role in recovery from the global crisis. For example, despite the announced intentions, IMF in many cases is still prescribing pro-cyclical policies that can unnecessarily exacerbate economic downturns in a number of countries. Such policies would be in violation of the international consensus to undertake a concerted effort to stimulate global demand.

49. At the United Nations Conference on the World Financial and Economic Crisis, various aspects of the need of many developing countries to borrow more to support output recovery and maintain social spending were discussed. To ensure that developing countries are not unduly constrained by policy arrangements from taking on more debt to support recovery efforts, the World Bank and IMF need to review the Debt Sustainability Framework, as was requested by the G-20 in its April communiqué. The Debt Sustainability Framework should be sufficiently flexible to take into account the circumstances of each country while still performing its role in preventing a reaccumulation of unsustainable debt burdens. The United Nations Conference also recognized the policy of temporary debt standstills between debtors and creditors, in order to help mitigate the adverse impacts of the crisis and stabilize macroeconomic developments.

50. There have also been suggestions for IMF and other international financial institutions to use their financing to address problems in the corporate and banking sectors, including support for bank recapitalization or the facilitation of the rollover of private external debt. Fund financing of member Governments has traditionally been used for the replenishment of foreign exchange reserves, sovereign debt repayment or intervention in the foreign exchange market. However, in the current crisis, Governments and their central banks in both developed and developing countries have used foreign exchange reserves and new borrowings to help their domestic financial institutions and corporations to repay international creditors. With the ongoing globalization of finance, these needs are likely to further increase.

51. Work is under way to modify IMF concessional lending facilities in order to enhance their usefulness to low-income countries. There is a consensus that lending by the Fund to low-income countries should be more flexible in light of long-recognized diverse country needs and growing exposure to global volatility. In addition to the recent doubling in access limits and norms under the Poverty Reduction and Growth Facility and the Exogenous Shocks Facility, the Executive Board has signalled support for a lending framework comprising the Poverty Reduction and Growth Facility, a concessional short-term financing facility similar

to the stand-by arrangement and a unified concessional emergency lending facility to address exogenous shocks and post-conflict situations. At their London meeting, G-20 leaders called on the Fund to provide $6 billion of additional and flexible financing for the poorest countries over the next two to three years. Along with additional bilateral contributions, proceeds from agreed sales of IMF gold, together with surplus income, may be used for that purpose.

52. In the context of lending reform and sharply higher demand for Fund financing, G-20 leaders pledged to triple the lending capacity of IMF to $750 billion, approve a general allocation of SDRs equal to $250 billion and, as mentioned above, at least double the capacity of the Fund for concessional lending to low-income countries. To bolster Fund resources as quickly as possible, it was decided to negotiate temporary bilateral credit arrangements with IMF totalling $250 billion, increase the New Arrangements to Borrow by up to $500 billion and expand participation in the New Arrangements to Borrow to additional, financially strong IMF members. There was also an agreement to implement the 2008 quota agreement as quickly as possible, which would increase the quota resources of IMF by 12 per cent, and complete the next review of IMF quotas by January 2011, accelerating the process by two years.

53. Bilateral borrowing arrangements and the expansion of the New Arrangements to Borrow are likely the most viable options to mobilize liquidity in a timely manner. However, they are considered by many Fund members as constituting only a temporary bridge to a permanent increase of resources through a general quota review.[5] Consequently, the borrowings of the Fund should not be seen as a substitute for a substantial quota increase, as they enhance neither the decision-making structure nor the legitimate basis of the Fund. In fact, borrowing from some member countries by an institution mandated to undertake surveillance over all members unduly creates conflicts of interest. Over the medium term, it is important from both governance and balance sheet perspectives that the quota mechanisms be restored as the primary basis of Fund lending.

D. The international system of payments and reserves

54. The outcome of the United Nations Conference on the World Financial and Economic Crisis recognized "the potential of expanded SDRs to help increase global liquidity in response to the urgent financial shortfalls caused by this crisis and to help prevent future crises" (General Assembly resolution 63/303, annex, para. 35) and called for further studies on that potential. In April 2009, the G-20 decided on a general SDR allocation by IMF equivalent to $250 billion. By doing so world leaders, for the first time since the late 1960s, recognized the need to significantly boost international liquidity by using an international reserve unit. Before the April 2009 decision, the cumulative total of SDR allocations was only SDR 21.4 billion (around $32.9 billion).

55. The ongoing financial crisis has brought to the fore the deficiencies of the present international monetary system, in which a national currency, the United States dollar, serves as a dominant source of international foreign exchange

[5] See the 24 April 2009 communiqué of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development, available at www.g24.org/04-09ENG.pdf.

reserves. Those deficiencies include growing global imbalances, exchange rate instability and the possibility of an erosion of confidence in the dollar as a reserve currency. The widespread use of greater exchange rate flexibility did not produce exchange rate changes that reduced trade and financial imbalances; in fact, it contributed to the inherent instability of the system. Exchange rate adjustments were not sufficient quantitatively and were often in the wrong direction, owing to the fact that the United States dollar, as a reserve currency, serves as a benchmark for many other currencies and an anchor for international asset prices.

56. In the era of globalization, the use by all countries of a widely accepted national reserve currency has its clear benefits, owing to network externalities. However, the costs of such an arrangement in terms of systemic instability may have started to exceed its benefits. Likewise, the costs for the United States associated with its role as a supplier of global reserves may also be rising. Increased imbalances have had an adverse effect on United States domestic demand and on external demand for United States products, as well as more generally on the potential ability of the country to maintain economic policy autonomy.

57. There have been suggestions to move away from the almost exclusive reliance on the United States dollar and towards a system based on multiple, competing national reserve currencies. However, such a system, according to many observers, might add an additional element of instability associated with exchange rate volatility among currencies that are close substitutes and that are used as reserve units, owing to the possibility of sharp shifts of international demand from one international currency to the other. Also, it would not solve the inequalities of the current system, as reserve assets would still be provided by industrial countries. Besides, developed countries issuing reserve currencies are likely to account for an increasingly limited share of the world economy. Hence, the demand for international reserves will likely grow faster than the capacity of those countries to smoothly supply them.

58. Discussions on an international currency have been gaining momentum. The international community should seize this opportunity to start working on the creation of a new, more stable and equitable international monetary system. While, unlike in the late 1960s, there is no issue regarding the provision of global liquidity, there are problems associated with the control of global liquidity and significant equity issues in the access by developing countries to such liquidity.[6]

59. The introduction of a full-fledged international reserve currency based, for instance, on the proposal made by economist John Maynard Keynes in the 1940s, may take a long time, as it requires extraordinary political will, vision and courage, which are still lacking. In this regard, it has been argued that a more realistic way of reform may be a broadening of existing SDR arrangements, which perhaps over time could evolve into a new and widely accepted world reserve currency.[7]

[6] For an extensive discussion of the global reserve system, see the Report of the Commission of Experts of the President of the United Nations General Assembly on reforms of the international monetary and financial system, pp. 92-103, available at www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf.

[7] See essay by Zhou Xiaochuan, Governor of the People's Bank of China, "Reform the international monetary system", dated 23 March 2009, available at www.bis.org/review/r090402c.pdf.

60. A step forward would be making the issuance of SDRs automatic and regular. It has been suggested that the size of the issues could be linked to the estimated additional demand for foreign exchange reserves resulting from the growth of the world economy. Also, there have been calls to issue SDRs in a counter-cyclical fashion in order to finance world liquidity and official support to developing countries during crises. One of the versions of the proposal to use SDRs in a counter-cyclical manner envisages the development of an appropriate mechanism for withdrawing SDRs should global liquidity become excessive or inflationary. It is worth noting that the procedure under which countries holding 85 percent of IMF voting power must agree before SDRs can be issued might not be time-efficient if the Fund were authorized to provide additional SDR liquidity in periods of liquidity shortage.

61. It is well understood that making the SDR an attractive unit in which to hold central bank reserves requires deep and liquid markets in SDR claims. To achieve this, the issuance and use of SDRs by IMF, Governments, banks and non-financial firms need to reach some critical mass. In other words, it will be necessary to overcome the coordination problem — prospective issuers should have evidence that others would do likewise. In the past, all attempts to commercialize SDRs were unsuccessful.

62. Another important issue is a settlement mechanism between SDR and national currencies to make the unit an acceptable means of payment in international trade and financial transactions. Such a system should be able to facilitate the direct exchange of SDR claims not only into dollars but also into all constituent currencies. At present SDRs are valued against a basket of currencies, consisting of the euro, the yen, the pound sterling and the United States dollar. For SDR to gain global prominence, the number of constituent currencies should be increased to include monetary units of both developed and developing countries.

E. Governance reform at the Bretton Woods institutions

63. At the special high-level meeting of the Economic and Social Council with the Bretton Woods institutions, the World Trade Organization and the United Nations Conference on Trade and Development held on 27 April 2009, there was a firm consensus that the current system of global economic governance was not adequate for today's challenges and thus there was a need for credible, representative and effective mechanisms for macroeconomic coordination with governance structures that are duly representative of the interests of all countries and that can exercise strong policy leadership. The scale of the crisis merits serious consideration of the flaws in global economic governance that it has exposed and of the need for eventual new mechanisms and institutions beyond those presently in existence, such as the proposed global economic council or some similar body. Other speakers in the meeting emphasized that the global community should work with existing institutions and respond to the crisis by rapidly strengthening them and augmenting their resources.

64. The strengthening of the resource base of the Fund and improving its lending toolkit to address the global crisis are constricted by slow progress in longer-term reforms to boost the governance and legitimacy of the Fund. To remain at the centre of the international monetary system, IMF needs a more representative, responsive

and accountable governance, reflecting the realities of the twenty-first century. The reform of IMF governance is therefore a prerequisite for all other changes involving the role for the Fund.

65. At its April 2009 meeting, the G-20 called on IMF to complete by January 2011 the next review of quotas, including further improvement of representation for emerging and developing countries. Work on a new quota formula to address the existing bias against developing countries is to start by October 2009. There is a consensus that the quota formula should be improved before it is used again. The next realignment of quotas in favour of emerging market and developing countries should go far beyond the initial modest outcome achieved during the 2008 spring meetings, which has yet to come into force.

66. The changes in voting power have thus far been insignificant compared with the changes that have occurred in the global economy. The 2008 quota and voice reform will basically lead to a realignment of existing shares, primarily through a redistribution among the group of emerging market and developing countries. In that regard, developing countries have indicated that over time quota realignments in both IMF and the World Bank should result in an equitable voting power distribution between developed and developing countries without diluting the quotas and shares of individual developing countries.[5]

67. To further democratize the IMF voting procedure and ensure that decisions affecting key aspects of the institution have the support of a majority of members, a proposal has been made to amend the Articles of Agreement to lower the voting threshold on critical decisions from 85 per cent to between 70 and 75 per cent. To better balance the interests of large and small countries, consideration should also be given to extending double majorities (support by three fifths of the members that have 85 per cent of the total voting power) to a wider range of decisions. At present, a double majority is required to amend the Articles of Agreement.

68. Another important issue to address is the composition of the Executive Board, in order to better reflect the realities of the global economy. In that regard, there have been proposals to reduce the size of the Board from 24 to 22 chairs by 2010 and to 20 chairs by 2012, while preserving the existing number of emerging market and developing country chairs.[5]

69. There is a consensus that consideration should be given to greater involvement of the Fund's Governors in providing strategic direction to IMF and increasing its accountability, which in the end would be made possible only by a more democratic distribution of voting power on the Board. As a possible immediate step, there have been calls to transform the International Monetary and Financial Committee into a council, as envisaged by article XII of the Articles of Agreement. A council consisting of ministers and governors is thought to provide a forum for coordination and for making strategic decisions critical to global stability.

70. It has, however, been argued that before the activation of such a council, a substantial and far-reaching reform of quota and voice should be accomplished. Otherwise, with the voting shares that prevail at the Fund at present, developing countries would have even less influence in IMF. Indeed, unlike the present

[5] See, for example, the statement by Timothy Geithner, Secretary of the Treasury of the United States, to the nineteenth meeting of the International Monetary and Financial Committee, held in Washington on 25 April 2009, available at www.imf.org.

consensus-based International Monetary and Financial Committee, the decision-making rule of a Council, as contained in the Articles of Agreement, would be the same as the one that applies to the Executive Board.

71. It was agreed by the G-20 in April and at the United Nations Conference on the World Financial and Economic Crisis in June that the heads and the senior leadership of the international financial institutions should be appointed through an open, transparent and merit-based selection process, with due regard to gender equality and geographical and regional representation. In order to ensure the legitimacy of the Fund and the World Bank as truly global institutions, it is important to achieve greater diversity among staff members, avoiding the disproportionate representation of only a few specific regions. The Executive Board will discuss the 2008 diversity report ahead of the 2009 annual meetings.

III. Conclusions

72. In a financially integrated world, the enduring success of regulatory reforms depends in large part on significantly enhanced international cooperation, coordination and communication among regulators.

73. The ongoing financial crisis underscores the need to redress the deficiencies of surveillance over mature financial markets and advanced economies and to better integrate macroeconomic and financial sector surveillance.

74. It is necessary to build an effective framework for enhanced multilateral macroeconomic and financial policy coordination against the backdrop of planned governance reform in the international financial institutions.

75. Despite recent positive changes in multilateral lending facilities, there is still room for further innovation in how official liquidity is deployed. Also, over the medium term, it is important that the quota mechanism be restored as the primary basis of expanded IMF lending.

76. The crisis has revived discussions on the international reserve currency. The international community should seize this opportunity to start working on the creation of a new, more stable and equitable international monetary and financial system.

77. Addressing global economic governance issues is a necessary prerequisite for all other changes in the international financial architecture. Therefore, the second round of governance reforms should go far beyond the initial modest outcome achieved in 2008.

Annex

Net transfer of financial resources to developing economies and economies in transition, 1997-2009

(Billions of United States dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009[a]
Developing economies	-4.0	-37.8	-124.8	-189.6	-160.0	-208.9	-302.4	-378.6	-576.5	-756.9	-807.9	-827.8	-447.7
Africa	-7.8	12.4	1.4	-31.9	-16.3	-5.3	-19.1	-37.2	-65.8	-81.3	-88.5	-109.3	38.4
Sub-Saharan (excluding Nigeria and South Africa)	6.6	11.7	8.5	2.9	7.3	4.6	6.4	2.5	-0.6	-10.8	-6.6	-12.8	29.7
Eastern and Southern Asia	-31.6	-128.4	-138.0	-120.8	-117.5	-146.0	-171.7	-179.5	-258.0	-376.9	-480.0	-407.0	-482.2
Western Asia	12.4	34.5	2.7	-35.3	-29.8	-25.2	-48.3	-77.3	-143.1	-163.2	-135.9	-239.3	-4.7
Latin America	23.1	43.7	9.0	-1.6	3.6	-32.4	-63.3	-84.7	-109.5	-135.4	-103.6	-72.2	0.8
Economies in transition	1.6	0.7	-25.1	-51.5	-33.3	-28.5	-39.0	-63.2	-100.3	-123.9	-105.9	-157.8	-22.0
Memorandum item:													
Heavily indebted poor countries	8.2	9.3	10.9	9.7	10.0	11.7	11.6	12.8	16.0	13.6	21.3	31.7	36.0
Least developed countries[b]	10.4	13.7	11.5	6.6	9.7	7.6	9.0	6.2	4.0	-4.2	-4.5	-9.9	28.2

Sources: Department of Economic and Social Affairs of the United Nations, based on the IMF World Economic Outlook, April 2009, and the IMF Balance of Payments Statistics.

Note: The developing countries category does not include economies in transition; hence, data in the present table may differ from data reported for country groupings in IMF sources.

[a] Partially estimated.

[b] Cape Verde graduated in December 2007 and is therefore excluded from 2008 onward.